Aberdeen Standard Investments

UK Real Estate Market Outlook

Q2 2020

“The UK is facing an unprecedented economic shock with a stark and widespread impact on the occupier market.”

Executive summary

- The Covid-19 pandemic has resulted in the UK facing an unprecedented economic shock, both in terms of the magnitude and the speed in which swathes of the UK economy have essentially been switched off. The ASI Research Institute (ASIRI) expects a contraction in GDP of more than 15% in the second quarter of 2020 and a fall of around 10% for the year as a whole.
- However, the base case assumes a vigorous and relatively rapid recovery, particularly given the magnitude of monetary and fiscal support already announced. The UK economy is expected to grow by more than 5% in 2021.
- The unprecedented economic conditions have had a stark and widespread impact on the occupier market, putting unique stress on leisure and hospitality businesses and severely disrupting most of the retail market.
- Away from consumer-facing sectors, activity has slowed dramatically. While many deals already in train are completing, new activity is necessarily constrained by the inability to inspect and uncertainty around taking occupation.
- After a flurry of deals in December, transaction activity was subdued in the first quarter even before the Covid-19 pandemic took hold. Excluding a single large student halls portfolio deal, there were only £7 billion of transactions, which is lower than any quarter since 2010, when capital values were considerably lower.
- The inability to inspect buildings and the challenges with co-ordinating professional services and documentation are likely to deter many investors from transacting. The second quarter is likely to feature very few deals indeed, with little confidence in where prices or values lie.
- We expect capital values to fall by more than 10% this year but, in our view, there will be significant dispersion across the sectors. While industrials are forecast to see stable capital values, it is likely that retail values – except supermarkets – will fall substantially, with rents under downward pressure and yields set to move out.
- We anticipate performance to diverge substantially across the risk spectrum in most segments. Significant relative outperformance of lower risk assets is set to come through later in the year – and for a protracted period if the economic downside materialise – as the degree of income risk at the asset level becomes clearer.

Economic outlook

- The Covid-19 pandemic has resulted in the UK facing an unprecedented economic shock, both in terms of the magnitude and the speed in which swathes of the UK economy have essentially been switched off. The ASI Research Institute (ASIRI) expects a contraction in GDP of more than 15% in the second quarter of 2020 and a fall of around 10% for the year as a whole.
- However, as a crisis rooted in the real economy rather than a financial crisis, the base case assumes a vigorous and relatively rapid recovery, particularly given the magnitude of monetary and fiscal support already announced. The UK economy is expected to grow by more than 5% in 2021.
- Despite the enormous scale of policy support, its transmission into the pockets of households and businesses is not instant and there are signs that the immediate stresses are forcing some companies into immediate action and pushing up unemployment. Downside scenarios exist, with a longer period of recessionary conditions. The likelihood of permanent damage to fixed and human capital increases in such scenarios, reducing productivity and growth.
- With UK-EU negotiations on hold, given the government’s full focus on Covid-19 and the practical challenges of face-to-face talks, ASIRI fully expects the Brexit transition period to be extended. A limited free trade agreement remains the most likely ultimate outcome.

Occupier trends

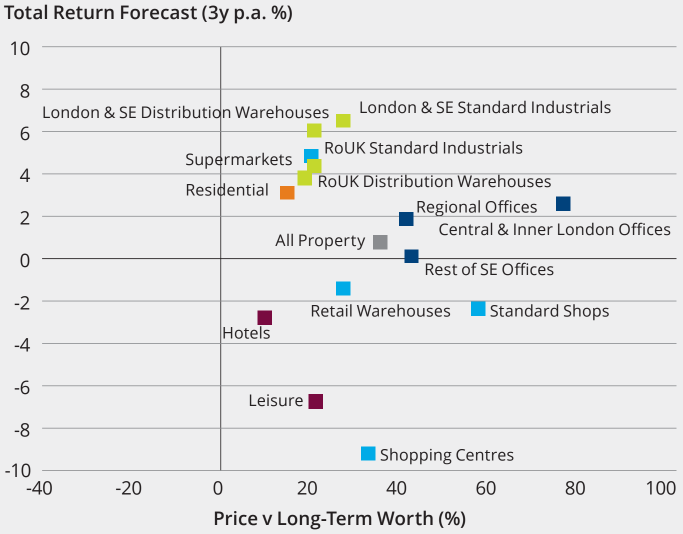
- The unprecedented economic conditions have had a stark and widespread impact on the occupier market, putting unique stress on leisure and hospitality businesses and severely disrupting most of the retail market. The focus has turned to rent collection, where some major landlords were able to collect less than half of the rent due for the second quarter.
- The government temporarily outlawed forfeiture of leases for non-payment to protect vulnerable businesses but even some of the more resilient retailers withheld rents. The situation will mean some difficult negotiations lie ahead to address those arrears.
- Laura Ashley was the first high-profile retail failure of the year and Debenhams has filed for a ‘light touch’ administration to protect it from legal action by creditors. Many other retailers are likely to be considering company voluntary arrangements.
- Away from consumer-facing sectors, activity has slowed dramatically. While many deals already in train are completing, new activity is necessarily constrained by the inability to inspect and uncertainty around taking occupation. There are some new, more urgent requirements in the distribution sector but they are largely short term and require flexibility.
- Offices across the country are largely empty as staff work from home or are furloughed. But the impact on fundamentals will depend on the duration of the economic shock. Increased voids and grey space for sub-letting are likely to depress rents, while this crisis may accelerate and accentuate the trend towards flexible working, with a greater emphasis on home working than previously assumed.

"Capital values are set to fall more than 10% this year with performance diverging substantially across the risk spectrum."

Investment trends

- After a flurry of deals in December, transaction activity was subdued in the first quarter even before the Covid-19 pandemic took hold. The quarter did feature Blackstone's £4.7 billion acquisition of the IQ student halls portfolio, an all-time record deal in the UK. The portfolio, which comprises 67 assets that are mainly linked to Russell Group universities, was acquired from Goldman Sachs and the Wellcome Trust.
- But there were only £7 billion of transactions excluding that deal, which is lower than any quarter since 2010, when capital values were considerably lower. Furthermore, the total includes a number of deals that have exchanged but not completed. In areas of the market where capital values are at risk of considerable decline, some of those deals could be derailed.
- Towards the end of the quarter, valuers across the industry and the RICS agreed wording for "material uncertainty" clauses to be attached to quarter-end valuations in March, with comparable evidence drying up and unprecedented set of circumstances on which to base a judgement.
- Similar to the occupational market, the inability to inspect buildings and the challenges with co-ordinating professional services and documentation, serve to at best delay deals but more likely deter investors from transacting. The second quarter is likely to feature very few deals indeed, with little confidence in where pricing lies and few sellers under pressure to market stock in such an environment.
- While the magnitude of the number reflects debt and other company-specific factors, the FTSE EPRA index recorded a total return of -30% in the first quarter. Credit spreads have significantly widened as the crisis has deepened, reflecting rising covenant risk relative to government bonds, which has read-across into real estate and the risk premium placed on income streams.

Chart 1: Market pricing versus long-term worth and three-year forecasts returns



Source: Aberdeen Standard Investments, April 2020.

Performance outlook and risk tolerance

- We expect capital values to fall by more than 10% this year but, in our view, there will be significant dispersion across the sectors. While industrials are forecast to see stable capital values, it is likely that retail values will fall substantially, with rents under downward pressure and yields set to move out. Supermarkets are the clear exception to this.
- The leisure sector also faces a material decline in values through 2020. While we expect a marginal fall in PRS residential values, the short-term performance of student accommodation is expected to be weaker. Student assets, alongside hotels, are also particularly exposed to downside risk to the economic outlook, where the impact of Covid-19 is more prolonged and income streams are severely impaired for a protracted period.
- Given our high conviction in the near-term outperformance of supermarkets, because of their much lower risk profile, it follows that we anticipate performance to diverge substantially across the risk spectrum in most segments.
- Holding the most robust and durable income streams may not be a major point of difference this quarter or next; history suggests this divergence emerges as the market approaches its nadir. But we expect significant relative outperformance of such assets to come through later in the year – and for a protracted period if the economic downside materialises – as the degree of income risk at the asset level becomes clearer. Our view that pricing is expensive compared with long-term worth (Chart 1) supports this ongoing low tolerance for risk.

Investment themes

- There is good reason to believe that the pricing of long income will continue to be well supported. But not all long income is secure and rising default risk will be closely watched through this crisis. Discernment in buying and selling opportunities will be critical; there may be a window of opportunity to sell long-lease assets where there is a mismatch in sentiment towards certain covenants across different investors.
- Urban logistics continues to be an area of the market we favour on a structural basis – likely amplified by this crisis – and one where the fundamentals remain supportive of rental tension. There is strong potential for consumers previously cautious around online shopping to gain confidence and retain a higher proportion of spending online after the crisis, which will drive increased demand for 'last touch' logistics in particular.
- Online grocery demand has increased substantially with the UK in lockdown but we don't believe this will have the same impact on logistics as discretionary goods. The crisis has exposed the constraints on capacity for home delivery and the importance of large superstores in fulfilment.
- Despite the expectation that void rates and tenant defaults may rise in the short term, we hold the view that the longer term fundamentals for the build-to-rent sector remain attractive. Income has historically been more resilient during periods of economic distress, with rents in the UK falling far less than the commercial market.

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The value of investments and the income from them can go down as well as up and your investor may get back less than the amount invested. Real estate is a relatively illiquid asset class, the valuation of which is a matter of opinion. There is no recognised market for real estate and there can be delays in realising the value of real estate assets.

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